



**THE CHANGING FACE OF GLOBAL FINANCE:  
CAN AMERICA'S CAPITAL MARKETS COMPETE?  
A TOWN HALL DISCUSSION MODERATED BY  
ATLANTIC SENIOR EDITOR CLIVE CROOK  
PANELISTS: WILLIAM MCDONOUGH, JOHN COFFEE,  
RICHARD CAVANAGH, AND THOMAS RUSSO**

*The Atlantic* Day of Ideas

November 18, 2006

Trustees Room

New York Public Library

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**ELIZABETH BAKER KEFFER:** Good morning. Welcome, everyone. My name is Elizabeth Baker Keffer, and I'm publisher of *The Atlantic*, and I wanted to welcome you to our Day of Ideas here in New York. New York is the last stop in a five-city tour celebrating *The Atlantic's* hundred-fiftieth anniversary, and we're very pleased to have you all here with us today. Across our history we have had publications from statesmen, historians, and pioneers, including several U.S. Presidents: Abraham Lincoln, John F. Kennedy, Theodore Roosevelt, Harry Truman. I thought I'd begin with a nod to our past, and a passage by Woodrow Wilson that fits the theme of our session. Even back in 1902, our president and scholar was concerned about the pressure of progress for American people and industry—how can we continue to innovate? Or where will it all end? And Wilson wrote then in 1902 in *The Atlantic*, "That rolling, resistless tide, incalculable in its strength, infinite in its variety, has made us what

we are, has put the resources of a huge continent at our disposal, has provoked us to invention and given us mighty captains of industry. This great pressure of a people moving always to new frontiers of new lands, new power, the full freedom of a virgin world. Who shall say where it will end?"

And that is the topic we will take up today with our panel on the weighty issue of "Can We Compete? America in the Global Marketplace." And sitting in the last session I was thinking this is appropriate in this room, because we have looking down on us, Africa, Asia, Europe, if you look around at the tapestries. So and here we are, America in the global marketplace. This is a conversation that we've hosted in each of the five cities that we've been in on our tour, with a slightly revolving cast of panelists. And across the entire tour, though, we've been fortunate to have Ernst & Young as our sponsor, helping to make it possible for us to bring together great minds with our readers across the country. Ernst & Young has been a partner to *The Atlantic* for some time now, helping us to convene thoughtful dialogue on key business issues of the day and doing a series looking at restoring trust in capital markets and now this series on the U.S. competitiveness around the globe. Ernst & Young and *The Atlantic* invite you to continue our conversation when we break, which will be around 12:10 or 12:15, with a light lunch to be hosted in this room. And it's my great pleasure in thanking Ernst & Young to introduce John Thomopoulos, who's a partner with the financial services practice of E & Y.

**JOHN THOMOPOULOS:** Thank you, Elizabeth. Good morning, everyone. Welcome to my hometown, I'm a born-and-bred New Yorker. For those of you visiting, welcome, and for those of you who share that background with me, you know how passionate we are about being New Yorkers, and the concept of globalization being based in New York—I truly believe we *are* the financial capital of the world, and what we are about to talk about is perfect for this setting of here in the public library of New York. On behalf of my partners and our people of Ernst & Young, I'd like to welcome you to this town hall. The question of "Can We Compete? America in a Global Marketplace." We believe at Ernst & Young that there needs to be a dialogue, a very *loud* dialogue, on this topic, on many points of view of this issue. The United States' competitiveness in the capital markets impacts our business sector's ability to access capital easily and inexpensively and the effectiveness of markets, not only here in the United States but throughout the world, and the prospects of industry, both service and manufacturing, in all regions, and ultimately the debate on the impact of investors. On a personal level, each of us in this room, our competitiveness will impact our standard of living, the mobility and the career prospects for

ourselves and future generations of Americans and future generations to come. At the end of this discussion we do invite you to join us for a discussion and dialogue, as Elizabeth said, with coffee and a light lunch.

At this time I'd like to hand the mike over to Clive Crook, the Senior Editor of *The Atlantic*. Clive joined *The Atlantic* about a year and a half ago, from *The Economist*, where he was there for approximately twenty years. He has made the move from London to Georgetown, I believe, in Washington. Welcome to the United States, Clive, I'm sure you've been here often, but now that you're here, part of us. He is a graduate of Oxford and the London School of Economics. And with that I'd like to turn it over to Clive. Thank you.

**CLIVE CROOK:** Thanks very much. Well, thank you all for coming. We're very compressed for time this morning, I warn you about that at the outset, as well as being compressed for space. **(laughter)** I don't think I've ever been so intimately accommodated on a platform with a panel of distinguished speakers before, and I'm in imminent danger of falling off, **(laughter)** so if you see that happening, give me a shout. Well, at the broadest level, the topic that's just been advertised, U.S. competitiveness, is so broad it's almost impossible to address in a short span of time. But, luckily, we intend to drill down into that topic a little more narrowly for the purposes of this discussion. And what we're going to be focused on here is the implications or the connections between American finance, American capital markets, and American prosperity. There are many other aspects to the broad issue of competitiveness, and I don't want to deflect you from raising these in questions towards the end—we'll give over the second half to questions. But at least for the first half of this discussion we're going to concentrate on finance and *exploit* the expertise of my fellow panelists. Let me introduce them without further ado.

First of all, Dick Cavanagh, who is the president and CEO of The Conference Board, which is one of the world's preeminent not-for-profit business intelligence research firms, previously the executive dean of Harvard's Kennedy School of Government. We have Jack Coffee, who is professor of law at Columbia University in New York, head of the university's central and corporate governance, a renowned authority on that subject, and the author of a new book, which I'm currently reading and warmly recommend, called *The Gatekeepers*, which is an authoritative discussion of many of the issues we're going to be touching on today. We have Bill McDonough, a vice chairman of Merrill-Lynch, former

chairman of the Public Company Accounting Oversight Board, and for ten years, as I'm sure you all know, president and CEO of the New York Fed. And finally Tom Russo, who is vice chairman of Lehman Brothers, in charge of their corporate advisory division, and another leading, genuinely global, authority on law and financial markets.

If you were putting a panel together to discuss the subject of American finance and American economy, and the interface between that domain and law, and regulation, and you could just choose *any* four people in the world, you'd probably choose these four people, so I just want you to understand that this is an *incredibly* distinguished group.

Let me try and frame, just take two minutes, to frame the topic that we're going to be discussing. The issue is really whether America's preeminence in finance, which has been so much taken for granted and for so long has been a source of American economic vitality, whether that preeminence is going to be sustained. Now there are some reasons to suspect that it's under threat. One is the danger of declining public confidence in American finance and, in fact, in American capitalism more generally, that followed the dot-com crash and especially the corporate scandals of recent years—WorldCom, Enron, and all the rest. Now there was a regulatory backlash to those scandals, Sarbanes-Oxley, and other initiatives, and some people argue that those measures are actually adding to the problem, that they were in some respects an overreaction or an incompetent reaction to the problem, and this, too, is now adding to the problem of lack of confidence in the capital markets. And a third factor which is particularly noticeable to me as a foreigner is America's, well, I will call it America's litigation culture. I think it is increasingly the case that to become a CEO in America, or a director of a public company, or a finance professional, exposes you to risks through litigation that you just don't face in those lines of work in other countries anywhere else in the world. I'm a little surprised that this aspect of the matter—aspect of our subject—isn't discussed in America more than it is. I know for a fact that it's on the minds of many Europeans who are contemplating a move to America. I think that's a big subject and I'm hoping we'll be able to get at least a couple of our panelists to address it in the course of this discussion.

Well, here's how we'll organize the discussion. I don't want to try to impose any particular structure or agenda on the meeting. I'm just going to put a question, a fairly general question, to each of our panelists, and invite them to speak for a short while. I've encouraged them to respond to each other's

comments in a conversational style, so that we can get some kind of interchange going. And then just to repeat—about halfway through, in about half an hour, I will turn the panel over to you for questions on either what we've been discussing or any aspect of the broader issue of American competitiveness.

Well, I thought I'd start with Bill McDonough, if that's all right. And ask you, Bill, if you could just help us to see why this issue of American capital markets, why the question of America's—the depth and the integrity of American capital markets—why that matters for the American economy more broadly—why that's even a concern.

**WILLIAM MCDONOUGH:** Well, I think the United States is the most competitive economy in the world, and the real economy—we adjusted in the mid-1990s to the reality of globalization, by lifting the American economy, essentially by investing in it, free investment by business leaders in order to improve labor force productivity, so the economy, that could only grow at two and a half percent per year, labor force productivity plus the growth in the labor force, from 1973 to 1995, as of '95, '96, it boomed and we could grow the economy at three and a half, four percent per year. What happened in the latter part of the nineties is we were doing that superbly. But at the same time, largely because of the reality of stock options as an important part of compensation, there was a growing apart of the American people and American investors from the people who ran companies. In 1980, the average CEO made forty times more than the average salary of the people who worked for him or her. By the year 2000, it was about four hundred times. That was kind of irritating a lot of American people (**laughter**) because the American dream is supposed to be, “Well, I can be like him, if he makes forty times more, but four hundred times? Maybe I'll never be able to get there.”

The result of that was that when the scandals came along, American investors said, “My God, how can we invest in companies if you can't trust their financial statements?” and the American people said, “I've decided I don't like those guys running companies, anyway.” That has to be understood to understand Sarbanes-Oxley. *Nobody* has been put in jail for violating Sarbanes-Oxley. *Nobody*. They got put in jail for violating laws that have been on the books for many, many years. Sarbanes-Oxley said, “We want American companies to be run differently,” and it passed ninety-seven to nothing in the Senate, four negative votes in the House of Representatives—you cannot get a resolution in favor of Mothers' Day with greater majorities than that, and then a highly conservative president said it's the

most important securities legislation since 1934/35 when Franklin Delano Roosevelt was president of the United States. You *have* to understand Sarbanes-Oxley and what's going on in light of this attitude on the part of the American people. So that's why we have to get and we are making immense progress in restoring confidence in the credibility of American financial statements and in the people running American companies. I think we're making great progress.

**CLIVE CROOK:** Okay. Jack, maybe you could pick that point up on Sarbanes-Oxley and how it fits into the wider issue of how we fix these problems in capital markets.

**JOHN COFFEE:** Well, let me start by endorsing everything that Bill just said. I think historically United States public corporations have had a lower cost of capital than their rivals in Europe, and that's because investors here had greater trust and confidence in the companies' published financial statements and reports. Now to the extent that you have a poor confidence in the published numbers, investors demand a lower risk premium over what they would demand in another country where the markets are more opaque, where the information is produced in a far more selective, episodic fashion, and where financial statements and the overseeing government regulator is not nearly as rigorous. The point here is that optimal securities regulation does more than just to protect the widows and orphans out there who we all want to protect, you also should reduce the cost of capital. When you do that, you benefit not only investors, you affect the Gross National Product, you make the whole economy stronger. That's what's at stake here, but there *is* a problem, and let me give you just one statistic to point out the problem.

In 2000, nine out of ten foreign issuers, nine out of ten dollars raised by foreign issuers in IPOs, new public offerings, were raised in the United States. In 2005, nine out of ten dollars by foreign issuers' new public offerings were raised *outside* the United States. That's a precipitous change. You cannot blame that, really, on Sarbanes-Oxley, because all of this was happening. It began in the mid-1990s and hit rock-bottom around 2001. So Sarbanes-Oxley doesn't have a direct causal responsibility. There are some—

**CLIVE CROOK:** Well, what was it then? If it wasn't SarbOx, what did it?

**JOHN COFFEE:** I think it is two things that has been making the foreign issuer community extremely disenchanted with the United States markets. One is a true distaste for what they see as U.S. legal imperialism, under which the U.S. believes that it has to establish the rules for all transactions, even though it has only a tenuous connection to the transaction. Two is what you pointed to already, a litigation environment that seems out of control to Europe—that's both civil and criminal litigation, they resent both of them—but they see private enforcement through class actions as something bizarre and beyond understanding. I'm going to give you just one example, bring this home with a simple example. If you are a foreign issuer, you might enter the U.S. today in a toehold, modest, tentative way, by listing a small quantity of stock through ADR's foreign exchange. One percent of your capital is traded in the U.S. but if you have a stock drop in Europe, your stock price falls twenty-five percent for any reason, what will happen in the United States is the plaintiff's bar will sue not just on behalf of the U.S. investors, but they will seek to bring a worldwide class action for multiple billions of dollars that threatens the corporate solvency of the company. You can't settle—you can't really litigate, go a trial in a multibillion-dollar class, you need to settle.

The message for the foreign issuer today is even a toehold entry into the U.S. puts you at risk for your very financial solvency because this worldwide class action may get brought that you have to settle. That's an area where I think we're seeing both litigation and U.S. legal imperialism. I don't think the U.S. has to be the worldwide arbitrator of what went wrong for citizens on five different continents, and if we say that, companies will stay offshore.

**CLIVE CROOK:** That's really interesting. Tom, can I get your take on that? Do you agree that the litigation issue is as big a deal as Jack's just been saying?

**THOMAS RUSSO:** Well, one of my jobs at Lehman is the chief legal officer. I normally don't admit that (**laughter**) in public but it is one of my jobs there, so I get to see the litigation firsthand, and I think what Jack said is true. If you feel that the probability of winning an action is, say, seventy or eighty percent—it never can be greater than eighty percent, any time there's a jury trial, no matter how good the facts are, you could lose it. And if the amount involved is relatively small, I'm using big numbers, but it would be relatively small in the scheme of things, say, forty, fifty, sixty, seventy, eighty million dollars, you would litigate that case, because of the probabilities, but once you get into the billion-dollar

range, you really have to think twice, and then when it gets to be two and three and four billion dollars, you really—it's very difficult to litigate the case, no matter what the probabilities are. So you could have a very frivolous action, or a relatively frivolous action, and be forced to, be forced into a settlement mode.

Now, put that in the context of U.S. competitiveness, which is why we're here. One of the figures that's often used is last year, twenty-four out of twenty-five of the global IPOs were outside the United States. This year nine out of ten of the biggest IPOs globally were outside of the United States. What's happening is other countries are getting more, for example, London just a few years ago went dramatically up, from I think it was five percent to twenty-five percent and increasing. And what's also happening is people when they come into the United States, they're going increasingly under what's called 144A, which is essentially a private transaction, where you don't have to register and you're not subject fundamentally to most of the U.S. regulations as opposed to using the public markets. I asked our capital-market group, because I'm involved with a—I'm on a steering committee of a group studying this, and Jack is an advisor to that same group, I asked them just to talk to our clients, and say, "Well, why do you go to Europe, or why do you go elsewhere, and not to the United States?"

And the reason is pretty simple, that the environment in the United States is just not good for corporations to be in. If you get here, you get sued, and what's happened with Sarbanes-Oxley, I mean, I personally think it went overboard, not the law, but some of the implementation of it, but it's not Sarbanes-Oxley, really, but Sarbanes-Oxley became sort of a tipping point. It's sort of a code word for *everything* else that has been wrong in the legal environment of the United States, whether it be regulation by enforcement, whether it be class actions, whether it be all the necessary work that's been done on Sarbanes-Oxley, and sometimes to the exclusion of other work, but whatever it is, SarbOx became a codeword for that, so foreign issuers just simply don't want to be here, and ultimately, if this continues, it's going to be a major problem because we're going to—we're beginning to lose now, but we will be losing more and more and more of one of the major industries.

And just to give you an idea, just the financial-services industry, which is a huge industry, now more than just the securities industry, is about 8.6, 8.7 percent of the GDP of the United States. New York State gets about 19 percent of its revenues from this industry in taxes, so this is—it's not just about

companies like ourselves. And, ironically, it's companies like ourselves and Merrill-Lynch, in some sense, we don't really care, because if we do an IPO abroad or if we do an IPO in the United States, you know, we still get paid either way, we get paid slightly more in the United States, but why? In part, because there's a bit of a litigation premium that's put on the underwriting spread. The underwriting spread in the United States is on average about 5.6 percent. In Europe it's roughly 3.5, 3.6 percent. But if you look at the money you spend in lawyers' fees alone. I mean, our company spends in total legal fees about a quarter of a billion dollars a year, and that's more than, you know, most people in this room make.

**WILLIAM MCDONOUGH** About half of that goes to Tom.

**(laughter)**

**CLIVE CROOK:** I was going to say.

**THOMAS RUSSO:** So, I think that's, and so it has a stigma in the United States, that it's just not a great place to do business in this industry.

**CLIVE CROOK:** This will seem like an odd question for a journalist to ask, but why isn't this more written about? This is not a very common perception, is it? It doesn't seem to figure very much in the political debate. SarbOx, yes, *that's* controversial, that's a big deal, or at least it *was*, I think that debate is fading, too. But one doesn't hear a great deal about the effects of a litigation culture on finance and competitiveness—why is that?

**JOHN COFFEE:** Let me add one point about this. It's only been over the last five years or so that the numbers of the securities class actions have soared to the point they're actually threatening the solvency of corporations. Time was, a very big class action settled for under a hundred million. They're now settling for over a billion dollars fairly commonly and, in the aggregate, about five years ago, the total amount of dollars paid in securities class actions was under five hundred million. If you look at 2005, and you throw the Enron settlement of about seven billion onto all other class actions, you get a number that's between sixteen and seventeen billion dollars. That has macroeconomic significance.

**RICHARD CAVANAGH:** I think, though, it's important to understand that the legal issues we're talking about are basically a protection racket or an extortion racket that's run by a handful of law firms against a very small group of extremely affluent clients. I've been sued twice as a director by Milberg Weiss, which is a law firm that currently is under investigation for its recruitment of plaintiffs, and I'll explain how it works.

**THOMAS RUSSO:** This is all, by the way, the cover story in this month's *Fortune* magazine—goes through the entire thing about how they did it.

**RICHARD CAVANAGH:** I'll give you an example. I'm a director of an insurance company. A plaintiff goes and buys seventeen insurance policies for ten thousand dollars from seventeen different insurance companies. They happen to be the seventeen largest insurance companies in the United States—

**THOMAS RUSSO:** As luck would have it.

**RICHARD CAVANAGH:** As luck would have it. All in the period of a month, this one man. Can you imagine the number of physical exams you had to go through? **(laughter)** And dealing with seventeen insurance agents in a month. But anyway, so, he then says, "You know what? All of these illustrations for this insurance I bought were fraudulent, because they all said that I might actually not have to pay as much a premium in the future as I do now if the stock market goes well, and, you know, here it is, six months later, and my premium hasn't gone down. I'll sue."

Now, the deal is that the law firm basically wants to get paid a settlement on behalf of all of the people who bought life insurance during that month period. And the fees—the legal fees are the first thing that they seek to be covered. So sixteen of the insurance companies settled. My company, because we were outraged by this, did not take the advice of our lawyers, we said, "This is crazy. You know, we've done nothing wrong." And so we proceeded to litigate it. It cost us a couple of million dollars in fees. The case was dismissed with prejudice by the federal court. Now, here's the issue.

**THOMAS RUSSO:** You won.

**RICHARD CAVANAGH:** Here's the issue. We won, but they won.

**CLIVE CROOK:** It cost you two million dollars.

**RICHARD CAVANAGH:** Because the system works that most people say, “Oh, gosh, if we go before the jury we could actually lose,” and so on and so forth, so it really is kind of an extortion racket. Now, why don't we hear about it? One, the people who are sued are not very sympathetic defendants. I mean, these are the fat cats who are getting sued. The second thing is that the plaintiff's bar is to the Democratic Party as evangelist Christians are to the Republican Party—*extremely* important as an interest group, and so there's a whole group of the political world that doesn't want to discuss this, *and* the people that are having the problem are so unsympathetic because basically they're the ones who are making four hundred times what the average worker is who are getting sued, so who cares? So that's why I think it's an issue that has—

**THOMAS RUSSO:** And it all comes out, remember, to the shareholders because ultimately the companies pay, it's something I've been saying for years, and I noticed an article you just wrote. That if you're a pension fund—or a mutual fund—so we're all involved in this in some way, and you own lots of different stocks, through the pension fund, through the mutual fund, what happens is that by and large the money is going from one corporation to the shareholders of another corporation, and you basically are the same, except for the huge amount that gets pulled out in legal fees, in settlement fees, and what have you, that come out of the pot, so that the American public as a whole doesn't benefit by this. It just does not. But the lawyers wind up in billions and billions of dollars getting benefit.

But that I think is the small part of the problem. The bigger part is that if you ask any CEO anywhere in the world outside the United States about the U.S. they will tell you, they will say, “You know, if I can avoid it, I will avoid it. I just don't want to get sued, I don't want to spend that time in court.” It has just given what is an enormously competitive market, a market where there is the least expensive market to raise money because of the liquidity, it's given all of these enormous competitive advantages we have and it's taken it—that CEOs, and this is not theory, you don't get twenty-four out of twenty-five IPOs

abroad when you have the most competitive market right here. There's got to be a reason for it, and the reason when you talk to the people is that they just don't want to be in this environment.

**WILLIAM MCDONOUGH:** I think one of the things that has to be done which is very easy to say and very difficult to do is we have to get back in the pre-2000 period when the American people in general and the American business leadership felt that they were in the same game and it was a game that everybody could win. Most American business leaders are thoroughly decent, honest people. They fall into the trap of saying, "Gee, we're mostly honest people, and so there are just a couple of bad apples." Well, that isn't what the American people think.

And so the leadership—they're making progress through the Business Roundtable, through Dick's operation, The Conference Board, through the Aspen Institute Corporate Governance Program. There is a beginning of a real effort in which people like me are extremely actively involved to try to restore the confidence of the American people in the private sector. Until and if we win that social and political battle, we're not going to have the American people restore their view that a dynamic wonderful private sector is good for me and good for my kids and good for my grandchildren. That's the game that has to be won.

**CLIVE CROOK:** I agree that that is absolutely the fundamental thing. But let me just come back, maybe this is where you wanted to pick up, Jack. I think a lot of people listening to you say that would still feel that there is an issue here, that a lot of U.S. CEOs have only themselves to blame, a lot of boards have only themselves to blame for this sort of culture of heightened suspicion and resentment because it is actually a fact that CEO pay for the biggest American companies has gone through the ceiling over the past five to ten years at a time when median earnings have been rising more slowly than inflation. What is the American public to make of that?

**THOMAS RUSSO:** Well, they know what they make of it. They don't like it.

**CLIVE CROOK:** What is the answer? I mean, what is the response?

**THOMAS RUSSO:** I think business leadership over time has to go back to the game that you actually pay for performance. I think the bad thing about executive compensation is not whether a guy who runs a company, or a woman who runs a company, very well makes a lot of money. Most Americans would say, “Right on,” for the same reason they think A-Rod does even if he isn’t great in the World Series or in the league series. I think what happens is when somebody makes a lot of money—

**CLIVE CROOK:** The perception is money for no performance.

**THOMAS RUSSO:** For no performance and that is really not how the game is supposed to be played, and that’s what the people see and that’s what they don’t like.

**CLIVE CROOK:** Do you think that, Jack, is that an accurate reflection of what’s going on, or is the media saying—

**JOHN COFFEE:** Let me say two things in response to what you’re saying. I’m sitting on the far left on this panel and I have to point out that one of the reasons the U.S. has had a lower cost of capital is that its securities laws are more rigorously enforced. Law on the books doesn’t mean that much, it’s law as it’s *enforced* that has the real impact on the cost of capital, on what investors see. I think that there is a role for private enforcement of securities laws, and I don’t think all securities litigation is frivolous, but I think right now the securities class action has become dysfunctional, because as Tom was starting to say, it basically results in this pocket-shifting wealth transfer. It’s ultimately shareholders suing shareholders for a recovery that goes from diversified shareholders to diversified shareholders, minus this 50 percent tax for lawyer’s fees, and that does systematically destroy the wealth of investors without getting anything desirable into the system. Now, to your point, we need to refashion our litigation system, but I think there is a role for private enforcement, and we have that lower cost of capital because we *do* enforce our laws.

**CLIVE CROOK:** Is there a straightforward fix, a politically feasible fix?

**JOHN COFFEE:** I think there are a number, but it’s highly technical. Let me take your second point about executive compensation, and I agree with much of what Bill is saying. The funny thing is the

consistency. We had this huge scandal in 2001, in 2002, in terms of corporate financial statements, where the basic problem was the premature recognition of income, that is managers tried to inflate the books to get the stock prices up because they were now compensated in stock options. That was all a change in the 1990s. We went from cash compensation to equity compensation in the space of about seven or eight years, a very rapid change, and corporate governance never keeps up with the market, it's always about five to ten years behind because it needs scandals before it moves.

Now we have a new scandal, stock options, and guess what? It's the same underlying force. If they're no longer cooking the books, they're now backdating the options. In the future I think we'll see—Sarbanes-Oxley has actually solved this problem—we're no longer going to see the backdating of stock options. We will for the future see what I'll call the manipulation of financial results. You'll put out the bad news on day one, drive the price down, issue the stock option at the low price, put out the good news on day three, and the stock will be issued in the middle of this vortex. That kind of game is very hard to enforce, but behind all this—

**CLIVE CROOK:** That sounds like the worst possible outcome to me.

**JOHN COFFEE:** Well, we have this problem that this rapid change to equity compensation, which *is* here to stay. We're not going to go away from stock options and equity—does produce a lot of managers gaming the system. And it needs boards that I think are monitoring this and trying to signal to the marketplace that they want to curb this. I think there are ways, again, that are technical, but you can curb it.

**WILLIAM MCDONOUGH:** We should remind the audience briefly how all the stock options stuff got started. The Congress in all its dignity in 1993 passed a law which was signed by the president, saying a company could not expense any compensation for an individual more than a million dollars a year unless it's performance-related. *Hello*, stock options. This was the undesired, obviously, because it was pushed, actually by people from the center left, Senator Levin of Massachusetts [sic] was the original sponsor of the bill, and it looked good at the time. The consequences have just been horrendous.

**RICHARD CAVANAGH:** Right, the unintended consequence was that a million dollars, which became the ceiling, actually became the floor, because no self-respecting CEO who was making less than a million dollars, you know, figured, “Well, if this is the statutory statement of what you’re supposed to get for being there, then I want it.” And then what they did in committee language was they said, “And by the way, stock options are a form of compensation that is performance-related,” and at that point stock options were free, meaning if you paid somebody in stock options, you didn’t have to record it as an expense, it was just kind of, you know, free money.

**WILLIAM MCDONOUGH:** Play money.

**RICHARD KAVANAGH:** And so guess what?

**CLIVE CROOK:** Unintended consequences. Well, I’ve got more questions of my own, but I promised to give the audience a chance, so, sir? Do we have—is there a microphone? Maybe we don’t need a microphone, it’s not a big room.

**Q:** Is globalization itself affecting, the way, affecting business? What I’m thinking of or asking—is it affecting ownership of companies? Is it affecting activism? To some extent, we’re seeing today some transparency in financial reporting. We may not have the same, comparable transparency yet in regulation, but what about simply does it matter where you do business because of globalization, have the companies changed?

**CLIVE CROOK:** Right, who wants to respond to that?

**THOMAS RUSSO:** I think what’s happened because companies have developed better regulatory systems—the UK is a good example with their FSA. Because firms are global in nature because there’s just a fluidity, I think people are able to go other places to do things and I think what you see, and all the data backs this up, is that people will wind up doing business where there is adequate regulation, but not what they perceive to be overregulation. And that’s why you’re having a significant, by any measure, shift out of the United States because the—and that’s what happening. Because these markets are now

real, in the past they weren't. They're regulated, in the past they weren't as regulated, and firms are global and so much of the liquidity is institutional in nature.

And this is the irony, and you talked about unintended consequences. I was trying to think of that movie, *Bruce Almighty*, where this guy wanted to be God, Bruce, and Morgan Freeman let him be God, and then he did a lot of things, and then there were unintended consequences. He brings the moon down while he's dating this woman, and it floods in India, all sorts of unintended consequences. And I think what's happened in this country is a lot of the legislation, even class actions, what have you, whether it be section 162-M, the tax law on deductibility, all of these things have these incredible unintended consequences, and as a result people *are* just deciding because they have the mechanism, and one of the unintended consequences is because of the institutionalization, large institutional players can buy into securities.

If you're a U.S. firm and you want to buy something, there's no reason you have to buy it in this country, you can buy it outside of this country, and you can buy it in this country through this what I said, 144-M, a sort of private offering, but if you're a common folk in this, a public investor, you then get foreclosed from buying any of these except to the extent that you're involved in a mutual fund or what have you as an investor there, but you cannot do that. So the market—a lot of these rules which were *intended* to protect the people who are reading the newspapers and the people who are concerned about these things, get foreclosed now from an awful lot of transactions. Some of it, maybe it's good they get foreclosed from, but they don't have the option to go into them except if they're in mutual funds.

**WILLIAM MCDONOUGH:** I think in brief, let me see if I can give you a shorter answer. In brief, you have a globalized economy and you have the nation state providing the legal jurisdiction. If you're running a globalized company, you simply, in the interest of your shareholders, have to take advantage of that, and you locate your activities in tax havens, and they're not funny places. Ireland runs one of the most successful economies in the world because it is absolutely genius at encouraging people to produce pharmaceuticals, to produce information services in the Irish Republic, and people take advantage of that. The nature of our ability to actually deal as world citizens with this phenomenon is very limited, because nobody is thinking that for a globalized economy you're going to have a globalized system of

governance. And therefore, I think what we have to do, especially, again, as business leaders, to try to restore the confidence is it has to be very clear that these things that we're doing are reasonable, and we're not playing funny games just for the sake of fattening up the bottom line in a way that is ultimately expensive, because to go back to what Dr. Coffee has been saying, the real name of the game is to reduce the cost of capital. You do that not by playing games, but by having investors have confidence in the management.

**CLIVE CROOK:** I think we'll take another question. I just can't help but point out that the European Union is leaning very heavily on Ireland at the moment to increase its corporate tax rate.

**WILLIAM MCDONOUGH:** Led by the British? I hope not.

**CLIVE CROOK:** Not by the British, but there is an attempt to stamp out that advantage, which is interesting. Madam.

**Q:** I thought that Dr. Coffee made a profound comment. There are lots of excellent comments. But he made a critical comment that I have been wondering about for a long time. He said we had security laws on the books and they were not enforced. And I'm thinking—and I would like comments from the panel—I'm thinking that in 1977, the Foreign Corrupt Practices Act changed, had an amendment that said that public companies had to maintain a system of internal control. Now, that's been on the books since '77. 2002, we have the Sarbanes-Oxley Act. When the comment letters went in to the FCC for the April 2005 round table, the major public accounting firms dismissed the situation, the cost of enforcing the internal controls amendment by saying it was a case of deferred maintenance. Why did not our public companies that are perceived to be so honorable and conscientious, why did they fail to do anything about internal control? As one academic found, 80 percent of the audits that were investigated in the study showed that the auditors depended on substantive tests only, they did not really determine—they just determined that they couldn't derive from internal controls. That seems very simple, it's much more complicated.

**CLIVE CROOK:** Thank you for the simple version. **(laughter)**

**JOHN COFFEE:** Your statements are historically accurate. We have had a requirement that public companies have adequate internal control systems since 1976. It was underenforced. Now, my basic point was that the U.S. does a *better* job of enforcement than other countries, but that provision was underenforced, and Sarbanes-Oxley in this very controversial provision called Section 404, requires today an annual audit, which is really putting teeth into that provision, because the auditor comes forward and tells you whether or not you have a material weakness. I think that provision needs a shakedown cruise, there's going to be some modification of it, but I think it's important, and I strongly support the idea that tough internal controls will reduce the cost of capital in the long run.

Why didn't we have a better system? Remember who hires the watchdog. If management hires the watchdog, it may sometimes prefer to have a lapdog than a watchdog. **(laughter)** One of the things that Sarbanes-Oxley did was give control over internal controls from management to the audit committee, and I think the audit committee is the appropriate repository for that responsibility. It first of all will be somewhat risk-averse, and you want the audit committee to be a little risk-averse in this area. Others may want to comment on that.

**WILLIAM MCDONOUGH:** Let me comment since I have had an awful lot to do as chairman of the Public Company Accounting Oversight Board with seeing this implemented. Not unrelated to the shock of the scandals and the concern for litigation, even companies that in fact had very *good* internal controls, and there were some who did, tightened them up even further, and then a lot of companies that didn't have much in the way of internal controls were putting in internal controls in a medium-sized company that might have been appropriate for IBM or General Electric but were absolutely crazy for them. And then the auditors came along, who were also desperately worried about litigation—they knew a lot about Arthur Andersen collapsing, and so what the best bet for an auditor is, don't take any risks, inspect the hell out of everything, and then nobody can sue you for not having done enough work. Now, one of the things the Public Company Accounting Oversight Board has said it's doing in its inspections of the audit firms is they will castigate them for doing too much work. In other words, we need to restore a balance for how much internal control do you really need depending on your business and how much internal control does the auditor really have to check before you're just doing it either for the sake of doing it, or for avoiding litigation, or running up the fees? This has to be improved, so you get a much better cost/benefit relationship out of that.

**CLIVE CROOK:** But doesn't this leave the auditors in an impossible position with, you know, litigators out there ready to pounce on any mistake and the regulators saying, "You're overdoing it"?

**WILLIAM MCDONOUGH:** Sure, that's why the main audit firms are saying we would like protection from litigation.

**RICHARD CAVANAGH:** I mean the analogy is that auditors fulfilling Section 404 are like physicians who are dealing with a medical examination in a highly litigious area, where it's kind of, let's do every test, and if we have to CAT scan the toes, we have to CAT scan the toes, but we're going to make sure that we've done everything that we can do, and I think that during the early 404 things that there were lots and lots of CAT scans that got done that probably don't need to be done every year, if ever.

**CLIVE CROOK:** Take another question. I've lost track of who was first. Sir, you.

**Q:** I had a question about the rise of buyout firms, taking companies public, giving themselves huge service fees, then taking the company public and trying to cash out that way. If you're talking about can American companies compete, these companies that are being bought out probably weren't competitive to begin with, but we're seeing a huge rise in this, and these companies are competing with one hand tied behind their backs, because they have to pay huge fees to the buyout firms, plus face competitors that don't have that burden.

**CLIVE CROOK:** That's a good question. Do you want to start on that?

**RICHARD CAVANAGH:** Sure, I mean buyout firms are not new to this culture, okay. Mr. Carnegie, who built this library, was the first buyout king, just to put this in some context, but given that, you've got an enormous increase in buyout activity. And, you know, some people believe that there is so much money that has gone into buyouts that there will be a self-correction of it, where, you know, there may be too much money chasing too few good deals. But it's true that the initial returns to the investors in buyout firms, the limited partners, have been very good.

Now, here's my sense of where it's going. I think that the best leading indicator of any sector that is about to crater is whether or not the graduating class of the Harvard Business School sends a majority of its graduates into that sector. **(laughter)** There have been three instances so far where a majority of the Harvard Business School went into a single sector. The conglomerates of the 1970s, of the class of '70, which I was in, which is why I've noticed this, real estate in the 1980s, and the dot-bomb, the dot-com boom of three years ago, where a majority of the class. Last year, 49 percent of the class went into private equity, so I think we'll see if—

**WILLIAM MCDONOUGH:** The other half went into hedge funds. **(laughter)**

**THOMAS RUSSO:** And the third half— **(laughter)**

**CLIVE CROOK:** I'm stealing that for my next column. Thank you. That's great. Yes.

**Q:** I'd like to get back to something that Mr. Crook characterized as the worst-case scenario a while ago, which is sort of the next move for corporations enacting stock options on the day between the bad news and good news. Now, that's something my first reaction would be as a market force responding the backlash against backdating stock options, so I'd like to compare that to another worst-case scenario, which is what Mr. Cavanagh described as the extortion of the fat cats, who are unsympathetic characters. To what extent are the lawyers responding to a market force of their own, working within the system they can get, how can either of those be, I guess, combated or reversed without more regulation, when it seems that less regulation is sort of what we're talking about.

**RICHARD CAVANAGH:** You don't see this.

**CLIVE CROOK:** How can lawyers be changed with Democrats controlling Congress?

**RICHARD CAVANAGH:** For example, if you go to Britain, where our moderator is from. How it works is, if you sue somebody and you lose in your suit, you pay the legal costs, in other words, loser pays, whereas in the United States, everybody pays their own, so there's no disincentive to file a class action suit. I mean, when I have class action suits filed against me, most often my name is misspelled

because they can't get them together fast enough, so, you know, I think that, right now, there's no disincentive to it, and you know, it's a free country, and, by the way, this is not to say that every class action suit is frivolous, that's not the case, there are honest-to-God—

**CLIVE CROOK:** But is there any likelihood that this issue is going to be addressed?

**JOHN COFFEE:** Well, actually, I think there's very little likelihood that *legislation* can affect class actions in a divided government. However, I think the SEC has rule-making power to do a number of different things. For example, the modern world of class actions is not the serial plaintiff that was being described earlier who owns a hundred shares in a thousand companies, that's the past. The modern world involves renting a pension fund. Many pension funds, particularly those that are public pension funds, have a controller who runs for office, either in the state or in the city. He never in the past could get political contributions, because who cares about the controller?

**RICHARD CAVANAGH:** Well, the famous one is Alan Havesi.

**JOHN COFFEE:** Well, we'll get to that, but without mentioning any names, if you look at the Louisiana controller, you'll find that all of his political contributions come from New York and Philadelphia law firms. Why did they do that? Because those firms want to rent a pension fund to be the lead plaintiff and give them control of the class action. I think there are ways that simply on the grounds of political integrity that we could say that a law firm that contributes to a controller may not for a period of time, two years, let's say, represent that controller and that pension fund in a class action. Strangely enough, that's exactly the rule today for municipal bond underwriters. You cannot make a contribution and underwrite a city's bonds. I have this naïve theory that maybe lawyers could be held to be as ethical as broker dealers, but that's naïve.

**(laughter)**

**CLIVE CROOK:** Romantic nonsense, I think. That sounds like a great idea to me. Some magazine ought to get behind that proposal. **(laughter)**

**Q:** I'd like to raise a countervailing opinion with regard to class actions and yes, they can be abused, but one of the problems with the corporate structure is that the vast majority of shareholders has very, very little power and as a result the only practical power that is left to them, among very few instruments, is class actions and we are leading, in that respect, the world, because in the rest of the world, the shareholders even have less power than they have here. So no wonder, if you have IPOs go up, now people prefer to have IPOs outside because they can get the IPOs under rules where shareholders will have less power. One could argue that we are going in fact in the right direction, maybe we should change course, but the right direction *is* to try to give shareholders more leverage and more power and the rest of the world should catch up with us.

**THOMAS RUSSO:** Yeah, let me answer that. First of all, I think you're dead wrong on shareholders don't have that power and the reason I say that is, what are you doing as a shareholder? You're not trying to run a company. That's not what you're doing. You're trying to make money from owning that company. You don't have the time, the energy to run a company, so by people selling the stock, *that* is the thing that sends the real message to companies and if companies are poorly run, they're going to get the message, their stock will be down, and people will be annoyed. CEOs, the average life of the CEO is a lot less today than ever before and one of the reasons is they *are* more accountable, they do make a lot more money than ever before, so that you do have power. The second is the unintended consequences. If you say, we're right, we're right, we're right, and we lose all this business, and we lose all these jobs, and we're losing all of this, you could really be right and it's a real Pyrrhic victory. And so, I think, you know, that, like all things—that's not saying class actions are necessarily bad, but we are the only country that has anything like this—

**UNIDENTIFIED SPEAKER:** What's "this"?

**THOMAS RUSSO:** The class actions in the way in which we have them. So it's not working. It's been abused and we're losing a lot of business and we're going to lose a lot of jobs because of it, so we have to weigh it. There are obviously benefits to it, but there's a lot of costs involved, and it's simply saying when you take the costs and the benefits, which is more. And I think that now, because of the dollars, because of the abuses, because of the business moving, the costs are greater than the benefits.

**RICHARD CAVANAGH:** Let's though, the presumption of the question in part is that the reason that IPOs are happening elsewhere is principally because of either regulation or because of the plaintiffs' bar. I think that's an overstatement, okay? I think that finance and financing and capital accumulation is a lagging indicator of wealth generation rather than a leading indicator of it. And if we look at—why was the largest IPO in history floated on the Hong Kong stock exchange? It may have been because it was a Chinese bank.

**WILLIAM MCDONOUGH:** I can assure you it was because we were the lead underwriter. And there's no way in the world, and it was done simultaneously in Hong Kong and Shanghai. There wasn't a chance in the world it could have been anywhere else. Quite a number of other IPOs in the recent past have been French publicly owned companies going private. You think they're going to do it anywhere but Paris? *Mon dieu!* (laughter)

**RICHARD CAVANAGH:** So there—some of it has to do with the fact that the United States is, while we're the geopolitical superpower, but we're beginning to share economic superpower status and it's natural that you'll have capital accumulation and capital generation in the areas where wealth is being generated, I mean, I think—and, by the way, I don't think that that should be something that we would lose sleep about. We lost sleep—twenty years ago we thought that we were all—in New York, people were sending their children to learn Japanese, because the Japanese interests had just bought Rockefeller Center and Pebble Beach and, you know, were buying major corporations and so forth. You know, and there was hand-wringing, and Japanese lessons, and so on. Nine out of the ten largest banks in the world were Japanese. You know what? That's not the case anymore. I mean, these things are fluid, they move.

**CLIVE CROOK:** Jack, you have something to add.

**JOHN COFFEE:** Someone's got to agree with our questioner in the audience, because he's raising a valid point. I do think it is the case that shareholders have less than the optimal level of power in U.S. corporate governance. The U.S. is different than the rest of the world. In the rest of the world, you primarily see concentrated ownership, there are controlling shareholders, and believe me, they can control their own managers. We and the UK have dispersed ownership, and there is an agency cost problem—that is, dispersed owners can't control the managers as well. I don't think, however, that the

class action is the best mechanism by which you control managers. The reality of the class action is the lawyer hires the client rather than the client hiring the lawyer.

The better mechanism, which is currently on the table, it's a major issue, is whether shareholders should have better access to the proxy statement, and be entitled to elect one or two directors through the mechanism of the corporate proxy statement. The SEC will be discussing this in December, and we currently have the curious spectacle of pension funds in Europe and Great Britain writing the SEC and asking the SEC to give them the same powers that they have in Europe, because they believe they have less power and access to the voting mechanism in the U.S. than they do in Europe. So there are ways in which I think the total balance may give shareholders a little bit more power but at the same time put a little less reliance on litigation.

**CLIVE CROOK:** I think we've got time for one more question. Madam.

**Q:** I'm wondering whether any of the panelists are involved as advisors to the people in our American public education system who are trying to prepare the next generation of young people so we can sustain American financial competitiveness. I'm just wondering if you have input—

**JOHN COFFEE:** I think you raise an excellent point. I just spent the last two years serving on a Canadian panel which was reexamining their whole securities regulation system. And what we decided was—the regulators know a lot. The disclosure system, the accounting, all of that is at the era of just small differences, but the individual, the individual investor, knows next to nothing, particularly about the critical acts, such as how to diversify your portfolio. We are raising in Canada and the United States a population that's close to financially illiterate, and I think that has to be a priority for securities regulation, to increase investor education, whether you do it in the high schools, or my own guess is, you probably do it in the workplace. It's people only around the age of forty, it's time to think seriously about retirement, and need to know how they diversify and how they do asset allocation. But I think you're right, the area that's least looked at in securities regulation, is how do you explain to the investor what he needs to know. We tell the professionals, the security analysts, everything they want to know, but the retail investor knows very, very little.

**WILLIAM MCDONOUGH:** I was very much involved in a thing, when I was president of the New York Fed, with a variety of things, but Classroom, Inc., for example, has an absolutely superb basic computer program for high school kids on how the financial system works, how you invest, so at the primary and secondary school level there is beginning to be a better educational system. Like most things in our country, we need a very much better educational system than the ones we've got to prepare our citizens to compete in a global economy, but just in terms of getting them to understand how the economy works and how the financial system works, there is a fair bit of progress.

**RICHARD CAVANAGH:** We just finished a survey, we at The Conference Board, of 461 heads of HR of basically the Fortune 500 companies asking them what do entry-level employees from high school and from college need to know, and then how do they stack up? Now, oddly enough, financial and economic education never made the list of what they needed to know, in the case of the 461 people who were responding, but in the case of high school graduates, there was basically wide-scale failure in terms of their preparation in everything. For example, 80 percent were found to be, or 80 percent of the respondents said that people who came to them as high school graduates were incapable of writing or following written instruction with skill. And so I think that the focus on business has been the rudimentary issues of how to get people to be able to be competent in an entry-level job as opposed to how to get them to be competent to invest their 401k. I think both need to be done, but I think that at the moment, the focus is on the rudimentary stuff, rather than on the economic education.

**CLIVE CROOK:** Do you have anything to add, Tom?

**THOMAS RUSSO:** I mean, I'm very much involved with education, but not in this. I chair the executive committee of the Institute of International Education, which does the Fulbright program, a bunch of other things. But the education—and I agree with what's been said before—that it's just terrible in the United States in terms of understanding just basic markets, and—but it's not going to solve this particular problem. I mean, the evolution is pretty clear. I really have a somewhat different feeling that I don't know how you really do change it. I meant, I think it's—if you look at capital flows of the United States, it's really—we've become so much of a service economy.

And this is just—the financial services industry, what we’re talking about here, to me it’s a little bit like a lot of other industries in this country. Other infrastructures are built up, we’re not doing the things we ought to do in part because maybe we’re not capable of it, we’re not as educated, but I don’t think that’s the real issue, and it’s just moving elsewhere, and maybe it’s right, there will be other industries that will grow or what have you, but what will really happen is that firms like two of our firms here, will just do more and more and more of our business abroad, and that’s exactly what is happening, whether you lead the IPO in China, or you do it in London, we’re in some sense indifferent, so I think that’s what’s going to happen—the U.S. firms will become more global, but the U.S. economy as a whole will only benefit marginally from that because we’ll have more and more people abroad and more and more jobs abroad.

**WILLIAM MCDONOUGH:** You need the best educational system in the world, which we have at the university level, and at the primary and secondary school in most communities it’s appalling, as a nation we have to fix that.

**CLIVE CROOK:** Well, that’s a sobering thought to end on, but we do have to end, we’ve run out of time. I want to thank the audience, first of all, you guys, for coming along, and for asking such sophisticated question. Very interesting to me, since I have moderated a panel like this in five cities now. This was much the most, you know, the highest level of questions, the most sophisticated questions. I guess that shouldn’t be surprising, this is New York, after all, but thank you very much for coming along and testing the panel and please join me in thanking our speakers. I thought they did a terrific job.

**(applause)**

**PANEL:** Thank you very much.